Chapter 6

MERGERS AND ACQUISITIONS

One of the main roles of the corporate financier is to initiate, execute and complete corporate acquisitions. Corporate financiers act as advisors to the most senior management and the Boards of Directors in major Mergers and Acquisitions (*M&A*) transactions. Despite the increase in the number of transactions in the past two decades, mergers are still not an everyday occurrence at most companies. Thus, corporate management requires the assistance and knowledge of professionals who have advised on many deals in the past.

The terms 'merger', 'acquisition' and 'takeover' tend to be used interchangeably, although there are specific definitions for accounting purposes.

Mergers affect all industries and all countries. Many deals involved bidders from one country acquiring a target in another (e.g., Pernod Ricard's (FR) $17.8 billion acquisition of Allied Domecq (UK) or Suez (FR) paying $13.9 billion for Belgium's Electrabel). Other deals are notable for their sheer size (e.g., the Time Warner–AOL stock swap valued at more than $200 billion at the time it was announced in 2000).

Figure 6.1 illustrates that, even in a 'slow' year, more than $1.3 trillion in deals are completed.

RATIONALE FOR M&A

Management give a number of reasons for entering into an M&A. One of the main reasons is to enable the

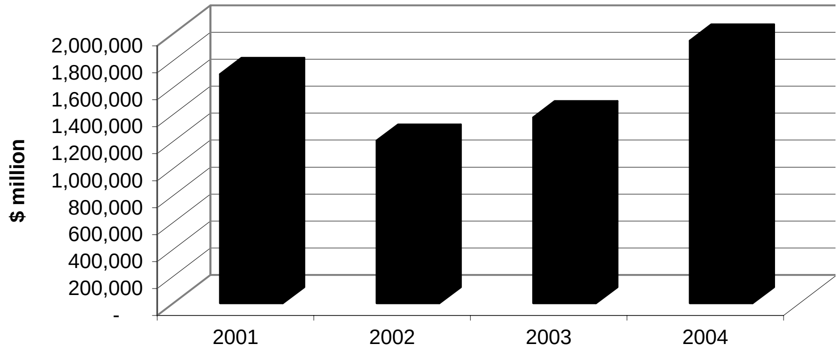

Figure 6.1 Global M&A.

company to grow more quickly than it could through organic growth. The growth may come from geographic expansion or the ability to offer new products and services or to reach new customers.

For technology-driven companies, the ability to capture a specific component or broaden its technical base can lead to transactions. For example, Cisco Systems, best known for manufacturing the routers and other equipment on which Internet traffic depends, made 70 acquisitions between 1993 and 2000.

Until the 1990s, many companies, known as conglomerates (e.g., Hanson, BET, Tomkins) were built on acquisitions. Senior management at these conglomerates felt that they had superior management skills and disciplines which could add value to their companies.

Using excess cash is also sometimes viewed as the reason behind acquisitions, although management of the acquiring company would not admit to this.

The only appropriate rationale for M&A is if the transaction(s) create value for the shareholders of the company. This may be through strengthening of the business, either by acquiring new or better products or better management. Value-creating acquisitions are almost always in industries of which the acquiring company already has a good understanding. Diversification for its own sake rarely creates sustainable value.

The senior corporate financier will often be involved in corporate discussions regarding the decision to undertake a transaction. Corporate financiers typically have a better sense of investor opinion of (specific) transactions as well as an understanding of the types of deals being done in other industrial sectors.

At this early stage, a junior corporate financier may be asked to assemble data on a wide range of potential targets or partners. While the bankers do valuations of these other businesses, the corporate executives are examining them from the perspective of strategic fit.

TYPES OF MERGER

Mergers (and acquisitions) are typically classified as one of the following:

- *Horizontal mergers* join companies that operate in similar lines of business. BP and Amoco in oil and gas; Total, Fina and Elf Aquitaine in the same industry; Royal Bank of Scotland and National Westminster Bank in banking; Sanofi and Aventis and, finally, Glaxo and Wellcome – subsequently, GlaxoWellcome with SmithKline Beecham to form GlaxoSmithKline – in pharmaceuticals. Horizontal mergers or takeovers allow the enlarged company to benefit from economies of scale and the ability to cut costs.

- *Vertical mergers* bring companies either closer to their customers or closer to their source of supply. The purchase of automobile dealers by manufacturers such as Ford and Vauxhall and others is an example. Ford also acquired Hertz, the care hire agency, but divested this subsidiary in 2005 for $15 billion to a buy-out group.
- *Diversification or conglomerate* mergers join companies operating in unrelated businesses. Managers of conglomerates make the claim that their business model allows for the more effective use of central services such as accounting and taxation and the ability to smooth earnings over a business cycle. During the 1990s and 2000s investors turned against conglomerates and conglomerate mergers, causing many of the conglomerates built up during the 1960s, 1970s and 1980s to be split apart. While the building of conglomerates created wealth for shareholders – for a time – the real winners were corporate financiers who aided first in the building (acquisitions) and later in the destruction (disposals) of the conglomerates. Of course, fees were payable in all transactions.
- *Financial acquisitions* are driven by the financial logic of the transaction. In general, financial mergers fall under the category of *Management Buyouts* (*MBOs*) or *Leveraged Buyouts* (*LBOs*) and related

names. The backers of such transactions are not generally long-term investors and there may be no strategic logic behind them. MBOs and LBOs are discussed more fully in Chapter 7.

- *Ego-driven* or 'me too' mergers are often initiated by chief executives in an industry who see others entering into mergers and decide that an M&A is necessary to the success of his company without thinking through the strategic logic.

MERGER WAVES

During the past century, five separate merger 'waves' have been identified by observers. The first three were very much US phenomena, while the last two waves have been more global in nature. The most recent merger wave, still in progress as this book is being written, has a very large European component.

During the 1890s, the first merger wave saw some of the nascent industries (rail, oil, steel) consolidate. This wave continued in the US until the end of that century. A further wave of industry consolidation took place during the 1920s in both the UK and the US. Industries such as automotive manufacturing coalesced around key manufacturers.

Between 1967 and 1969 a large number of 'conglomerate' mergers took place in the US. Most of the offerings were made on a share for share basis, with the fastest growing conglomerates able to offer the most attractive terms, as their shares were most highly rated (i.e., they exchanged high PE ratio shares for low).

In the late 1980s the first round of financial mergers took place. These were a result of cheap and plentiful credit and many corporations willing to sell non-core businesses (many of which had been acquired in the conglomerate merger boom). The pinnacle, and for many, the end of the boom, was the acquisition of RJR Nabisco by the New York LBO firm Kohlberg, Kravis & Roberts (*KKR*). *Barbarians at the Gate* is an excellent description of the transaction.

The 1990s merger wave continued into the next century. From 1994 to 2000, companies in industries as varied as banking, pharmaceuticals, telecommunications and oil and gas have been merging to gain size and 'critical mass'. After a brief respite following the bursting of the Internet bubble, M&A activity has increased again (see Figure 6.1). One of the main differences about the final wave of the 20th century is that it involved companies making significant cross-border acquisitions.

FINANCING THE TRANSACTION

There are three main alternatives to financing an acquisition. The bidder can offer cash for the shares of the target, it can offer its own shares or it can offer a combination of the two. Other alternatives, such as offering debt securities and preference shares, are also possible, but used less frequently as they tend to complicate the decision the target shareholders must make regarding the value of the offer.

During the 1980s' merger wave, numerous transactions involved a complicated mix of securities offered in consideration for the target's shares. This often made evaluating competing offers extremely difficult. Unique among these securities were Payment In Kind (*PIK*) bonds. Bidders would offer target shareholders partial payment in PIK bonds – bonds that paid, in lieu of interest, only more of the same bonds.

Many mergers during the telecoms/Internet mania involved swapping one company's overvalued shares for another's – no cash involved. Since the bursting of the bubble, cash has become the preferred consideration in takeovers.

All cash offers have a number of advantages. The price to be received by the selling shareholder is obvious and easily quantified. The selling shareholders can use the cash received to reinvest as they please – they are not forced to become shareholders of the bidder. By offering cash, the bidding company does not dilute the ownership position of its current shareholders as would happen if it offered shares to the target. One disadvantage to a cash offer is that it triggers a sale and potential capital gains tax liability for the selling shareholders.

The advantages to offering shares in an acquisition are largely the opposite of the cash offer. Target company shareholders are able to defer any capital gains tax liability until they sell the shares of the merged entity, at their own timing. In addition, the target shareholders are able to maintain an interest in the ongoing business of the new company.

Bootstrap transactions

Many investors and stock market commentators focus on the impact an acquisition or merger has on the successor firm's Earnings Per Share (*EPS*). In some cases, the source of financing for the transaction will have an immediate impact on EPS. For example, if the acquisition takes place in early 2006, the accountants prepare a *pro forma* income statement, which shows the EPS of the acquiror had it owned the target for all of 2005. This would include the additional revenues, costs and, most importantly, the additional interest expense incurred by taking on debt to make the transaction. As the thinking goes, if the acquisition is 'accretive' to earnings and EPS (i.e., increases), the transaction is a good one. If it is dilutive to earnings, the deal is bad.

Where equity is to be used (i.e., in a merger, or an acquisition where shares are offered), the effect on EPS is immediate and will be examined by analysts and investors. As a general rule if the existing Price Earnings (*PE*) ratio of the acquirer is higher than the 'exit PE' at which the target is acquired, the acquirer will show, on a *pro forma* basis, an immediate enhancement of EPS. This effect is often referred to as the bootstrap effect. If the acquirer's PE is lower than the target's PE, dilution results.

Between 1966 and 1972 faddish conglomerates used high-priced stocks to acquire a wild assortment of companies. Often they were able to create the illusion of growth by using their high-multiple stocks to buy low-multiple companies. If such a deal is accounted for as 'pooling' rather than a 'purchase', the effect is to give an artificial boost to the earnings per share of the acquirer. But once the dealing pace slows – and investors finally see through the accounting – the magical growth vanishes.

Forbes Global, 16 October 2000

REGULATION OF M&As

In the M&A business, one of the most important functions of the corporate financier is to ensure that the deal timing, structure, etc, adheres to local rules and regulations.

Mergers, acquisitions and takeovers involving public companies in the UK are subject to regulation by the *Panel on Takeovers and Mergers* (the Takeover Panel) and the Financial Services Authority (prior to 2000, the London Stock Exchange was responsible).

The Takeover Panel (a self-regulatory organisation) is responsible for the *City Code on Takeovers and Mergers*, published in a blue binder and, hence, popularly known as the *Blue Book*. The *Blue Book* is a voluntary Code which does not have the force of law, but reflects the opinions of professionals involved in M&As. The Code provides a framework under which acquisitions and mergers of publicly quoted companies can take place and is designed to ensure fair treatment of all shareholders in an acquisition.

In the UK, when monopoly and anti-trust considerations arise because of the size of the participants in a transaction, the *Office of Fair Trading* (*OFT*) can refer the transaction to the *Competition Commission* (*CC*) for review. If the CC finds that a monopoly may be created to the detriment of the public interest, it refers the decision to the Secretary of State for Trade for final resolution. Very large mergers or those with cross-border implications are subject to vetting by the EU. Such referrals can take considerable time and any bid's timetable is deemed to have been suspended until competition issues have been resolved.

Key elements of the City Code

The authors of the Code realised that it was impossible to devise rules in sufficient detail to cover all eventualities that might arise in a transaction. Thus, it is a collection of specific rules and general principles. The Code's general thrust is set out in the paragraph below:

Each director of an offeror and of the offeree company has a responsibility to ensure that the Code is complied with in the conduct of an offer. Financial advisors have a particular responsibility to comply with the Code and to ensure that an offeror and the offeree company, and their respective directors, are aware of their responsibilities under the Code and *will comply with them. Financial advisors should ensure that the Panel is consulted whenever relevant and should co-operate fully with any enquiries made by the Panel. Financial advisors must also be mindful of conflicts of interest.*

Selected general principles:

- All shareholders of the same class of an offeree company must be treated similarly by an offeror.
- During the course of an offer neither an offeror nor the offeree company, nor any of their respective advisors, may furnish information to some shareholders which is not made available to all shareholders. This principle does not apply to the furnishing of information in confidence by the offeree company to a *bona fide* potential offeror or *vice versa*.
- Shareholders must be given sufficient information and advice to enable them to reach a properly informed decision and must have sufficient time to do so. No relevant information should be withheld from them.
- All parties to an offer must use every endeavour to prevent the creation of a false market in the securities of an offeror or the offeree company. Parties involved in offers must take care that statements are not made which may mislead shareholders or the market.
- Rights of control must be exercised in good faith and the oppression of a minority is wholly unacceptable.
- Where control of a company is acquired by a person, or persons acting in concert, a general offer to all

other shareholders is normally required; a similar obligation may arise if control is consolidated.

At the time of writing, UK officials were attempting to determine how to integrate the EU Takeover Directive consistently with the Code.